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CITY COUNCIL REPORT  
PUBLIC

DATE: ~~October 10, 2019~~ **October 29, 2019**

TO: Mayor, Vice-Mayor and City Council

FROM: Rick Tadder, Management Services Director  
Sandy Corder, Revenue Director  
Brandi Suda, Finance Director

CC: Greg Clifton, Shannon Anderson, Shane Dille, and Leadership Team

SUBJECT: FY 2019 Transaction Privilege Tax Revenues and Impact on Budget **(REVISED)**

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**Summary**

The purpose of this City Council Report (CCR) is to provide information regarding changes in Fiscal Year (FY) 2019 revenue projections and the impact on the City of Flagstaff (City) FY 2020 budget, as well as ongoing years. The information is primarily related to major Transaction Privilege Tax (TPT, or sales tax) revenue sources which impacts the General Fund.

Preliminary information was presented to the City Budget Team on August 26, 2019, as an initial indication of a decline in projections, though **preliminary** FY 2019 revenues were higher than the actual budget. The Budget Team and the City Manager requested additional research to enable an informed discussion with City Council. Accordingly, a follow up staff presentation and discussion will occur with Council at the work session on October 22, 2019.

**Key Considerations**

- The City ended FY 2019 with TPT revenue 4.13% below the prior year's revenue. ~~Due to conservative budgeting, the TPT revenues are still above budget by approximately \$251,724 and below mid-year projections by approximately \$620,000.~~ **Sales tax revenues for FY 2019 are \$490,440 below budget and \$984,503 below February projections.**
  - As of December 2018, overall TPT revenue remained above the prior year's receipts and projections;
  - Revenue estimates presented at the February 2019 Budget Retreat, were based on a very healthy first half of the FY 2019;
  - In March/April 2019 staff began to recognize declines in TPT revenue for returns through February 2019, for monies received from Arizona Department of Revenue

(ADOR) in January. Staff initially attributed the decline to timing issues with revenue collections as all other Arizona economic indicators remained strong.

- However, to-date, revenue has not rebounded to projected levels.
- TPT revenues have declined over the prior year in the following taxable income categories:
  - Retail sales, includes the sale of any tangible personal property such as cars, furniture, equipment, etc. (3.4% decline); and
  - Construction contracting, including general contractors, speculative builders, and owner-builders (33% decline).
- Other lesser factors contributing to a decline in TPT revenues are:
  - Overcollection in FY 2018, when ADOR began centralized TPT collection;
  - Refunds made to taxpayers in FY 2019 (\$168,000). Some of these refunds are attributable to new tax exemptions.
- For FY 2020, City TPT revenues are down only 1.3% over the prior year collections for July and August.
- The chart below summarizes FY 2019 Sales Tax Revenue (Revised):

Summary of Sales Tax Revenue General Fund Revenues (1% Collections)					
Category	Budget	FY 2019 Projection	FY 2019 Actual	Budget vs Actual	Projection vs Actual
Utilities	\$ 1,053,381	\$ 1,085,800	\$ 1,073,200	\$ 19,819	\$ (12,600)
Telecommunications	\$ 267,800	\$ 245,000	\$ 219,657	\$ (48,143)	\$ (25,343)
Restaurants/Bars	\$ 2,884,000	\$ 3,000,000	\$ 2,898,463	\$ 14,463	\$ (101,537)
Amusements	\$ 97,850	\$ 112,000	\$ 106,849	\$ 8,999	\$ (5,151)
Commercial Property Rental	\$ 950,000	\$ 1,200,000	\$ 1,183,937	\$ 233,937	\$ (16,063)
Personal Property Rentals (TPP)	\$ 680,830	\$ 660,000	\$ 686,618	\$ 5,788	\$ 26,618
Construction Contracting	\$ 2,148,760	\$ 2,200,000	\$ 1,881,039	\$ (267,721)	\$ (318,961)
Retail	\$ 10,362,148	\$ 10,500,000	\$ 10,013,312	\$ (348,836)	\$ (486,688)
Lodging Under 30 Days	\$ 1,493,500	\$ 1,500,000	\$ 1,525,680	\$ 32,180	\$ 25,680
Use Tax	\$ 824,000	\$ 740,000	\$ 671,093	\$ (152,907)	\$ (68,907)
Other	\$ 122,665	\$ 136,197	\$ 134,646	\$ 11,981	\$ (1,551)
<b>TOTAL:</b>	<b>\$ 20,884,934</b>	<b>\$ 21,378,997</b>	<b>\$ 20,394,494</b>	<b>\$ (490,440)</b>	<b>\$ (984,503)</b>

## **History of Transition to ADOR Collection**

Since territorial times Arizona cities have had their own local sales tax authority, including authority for tax levy and collection. All 91 Arizona cities and towns have adopted the Model City Tax Code, which originated in 1987. Over time, businesses have lobbied the State Legislature for increased uniformity and centralized state tax administration.

In May 2012, then Governor Jan Brewer issued Executive Order 2012-01 calling for the creation of a Transaction Privilege Tax Simplification Task Force. The Task Force was charged with: "...reviewing, identifying, or developing proposals that would simplify the TPT code and TPT

practice in order to alleviate taxpayer frustration, improve compliance, and avoid redundancies. Specific areas of focus shall include, but not be limited to: ... a. options for a single point administration to avoid redundancies; b. identification of differences between state statute and the Model City Tax Code; c. standardization of definitions of taxable transactions between taxing authorities."

In 2013, the Arizona Legislature adopted HB2111 requiring ADOR to administer and collect all local transaction privilege, use and licensing taxes, in addition to all state taxes (a single point of return). Starting January 1, 2017 ADOR began administering all local taxes.

All businesses now must file both state and local tax returns with ADOR. ADOR has entered into an intergovernmental agreement with all 91 Arizona cities and towns, and each municipality must pay a proportionate share of the state's local tax administration costs.

In response to the ADOR assumption of local tax administration, Flagstaff reduced and repurposed staff of the City's local Sales Tax Unit. The City kept one sales tax auditor until that position became vacant and was difficult to fill due to the specialty background needed. We reorganized by outsourcing. As a result, the City decided to contract with a sales tax auditing firm to perform a portion of our sales tax auditing and we added a collection specialist.

In FY 2018, during the initial phase of ADOR transition, TPT and use tax revenues for Flagstaff grew by 11.83% over the previous fiscal year. This was supported statewide by the Joint Legislative Budget Committee (JLBC) Staff October 2018 Revenue and Budget Update Report stating a "stronger-than-expected economic growth" with revenue growth of 6.9%. Though Flagstaff's nearly 12% was double the combined JLBC 6%, it was noted that a large portion of Flagstaff's increase in sales tax revenues was due to construction, and the newly enacted 1% use tax.

### **Federal Tax Cuts**

On December 22, 2017 the federal government signed into law the largest income tax overhaul in 30 years, the "Tax Cuts and Jobs Act." JLBC reported in January 2018 that Income Tax Payments doubled and they didn't know the reason. Many changes were being implemented simultaneously with a wide difference of opinion on the long run impact to the economy with 90% of 62 economists in a Wall Street Journal survey concurring of a growth over the next two

years. The survey reported the historical context was by the end of '19, we would have tied the record for post WWII expansion.

All data supported Flagstaff's seemingly rapid growth. However, as previously noted, in March/April 2019, City staff began to notice a decline in Retail and Construction Contracting TPT revenues starting with the January 2019 tax collections. Staff ascribed this to timing issues after reaching out to other municipalities and Flagstaff's contracted auditor, comparing trends. All reports were that these taxable sectors were remaining strong.

### **Working with ADOR**

City staff is working with ADOR to obtain a better understanding of what local tax revenues are being collected, and to identify any economic trends. ADOR has different software and reports than the City had in the past. Staff has seen swings in sales tax collections month over month during the time ADOR began collecting on the City's behalf. Our reports are based on the state cash collection and not based on the period of the sales tax reporting. We receive weekly payments from ADOR, however depending on when the end of the month falls, payments may be recognized in the wrong period.

The City's contracted auditor followed up with construction businesses and collected over \$100,000 in delayed reporting, further supporting staff's assertions. City Community Development staff will be asked to identify any downturns in construction permitting that will affect Construction sales tax revenues.

Staff also noticed lower than normal collections in several taxable categories. Staff determined ADOR was issuing refunds, though there were no unique reports to identify the amounts or categories for these refunds. Staff has since designed a way to determine the amounts of refunds and are now tracking these monthly. The result over the previous fiscal year for collections and refunds are:

- Approximately 33% decline in Construction
- Approximately 3.5% reduction in retail
- More than \$168,000 in refunds across all categories

As we began to close FY 2019, and the full impact of the decline was recognized, staff reached out to ADOR, beginning intensive efforts to determine all reporting mechanisms, training, and

mutual insight into trends impacting Flagstaff, as well as Arizona. Discussion has also commenced regarding the changes made at the time of the transition to ADOR.

ADOR brought its local tax administration team to Flagstaff on August 26, 2019. This was a positive and impactful meeting, giving us all a better understanding of how we can work together to improve local tax administration. Members of Management Services and City Management attended this meeting.

ADOR reported that it has modified its original intent and is relying upon municipalities to continue local tax auditing and monitoring, to inform ADOR of businesses who may be out of compliance, and a greater reliance on partnership.

The City currently does not have the staffing to conduct the local tax auditing and monitoring that ADOR suggests is needed for a successful partnership. If what is being communicated now had been communicated in years prior, we would have made different staffing decisions.

However, the Revenue team is regrouping with current resources, and working with ADOR and other municipalities through the City Tax Administrators Council (CTAC) to devise new methods to provide local taxpayer education, monitor local tax compliance and track revenue within current means.

### **General Fund Update**

Revenue staff is looking at all major General Fund revenues, in addition to local TPT and use tax, to understand how they are performing. These categories include:

- State Shared Sales Tax;
- State Shared Income Tax;
- Auto Lieu and
- Franchise Fees for use of the local public rights-of-way (electric, natural gas, and telecommunications utilities, and cable television).

The continued growth in the Arizona economy and population has had a positive impact on the State shared revenues. Franchise Tax in FY 2019 fell slightly behind due to timing issues in receipt of payments.

The following is a Summary of the Major Tax Revenue Sources (Revised):

Summary of Major Tax Revenue Sources					
Category	Budget	FY 2019 Projection	FY 2019 Actual	Budget vs Actual	Projection vs Actual
Sales Tax	\$ 20,884,934	\$ 21,378,997	\$ 20,394,494	\$ (490,440)	\$ (984,503)
Stated Shared Urban Revenue	\$ 8,719,302	\$ 8,716,221	\$ 8,716,166	\$ (3,136)	\$ 55
State Shared Sales Tax	\$ 6,905,944	\$ 7,100,000	\$ 7,256,985	\$ 351,041	\$ 156,985
Auto Lieu Tax	\$ 3,108,690	\$ 3,200,000	\$ 3,430,071	\$ 321,381	\$ 230,071
Franchise Fees	\$ 2,546,234	\$ 2,573,755	\$ 2,551,767	\$ 5,533	\$ (21,988)
<b>TOTAL:</b>	<b>\$ 42,165,104</b>	<b>\$ 42,968,973</b>	<b>\$ 42,349,483</b>	<b>\$ 184,379</b>	<b>\$ (619,380)</b>

What do these changes in Major Tax Revenue Sources mean for the General Fund in FY 2020 and future years? Finance staff has updated the General Fund 5-Year Plan based on the updated sales tax projections. The downturn in revenues was not expected, but the City has been planning for an economic correction in future years, and therefore the downturn in revenues is not devastating to the General Fund 5-year plan. Due to the City's conservative estimates and practices, the General Fund 5-year plan is still structurally balanced.

Actual FY 2019 expenditures came in \$2.4 million (4%) under the FY 2019 Year End Estimate. We can use this underspending in FY 2019 to cover the FY 2019 and FY 2020 revenue shortfalls and still have an estimated unrestricted fund balance of \$13.5 million at the end of FY 2020. This is \$300,000 higher than originally projected as part of the FY2020 Budget adoption and above the 20% minimum fund balance reserve policy. We are showing a \$1 million shortfall in revenues in FY 2021 through FY 2024 compared to originally projected. When budgeting sales tax revenues, we do not assume 100% of sales tax revenues are ongoing. We set aside a portion of the most volatile sales tax revenues (construction and automobile retail) to be used for one-time requests. We are able reduced these one-time set aside in these 4 years from \$1.2 million to \$200,000 annually to compensate for the reduction in revenue projections to balance the General Fund 5-year plan.

In addition, the City's 5-year plan still has funding for a 2% merit increase for employee compensation planned for FY2021(\$1 million) and \$160,000 annually for employee health insurance cost increases. However, Finance staff anticipate limited one-time and ongoing resources for new budget requests in the General Fund for the Budget FY 2021 due to the decline in revenues.

In FY 2020, the City embarked on a new Priority-Based Budgeting program that will be completed over a several year period. We anticipate this new way of looking at the City budget will help us prioritize our spending of City resources.

### **Closing comments**

Management Services will continue to focus on sales tax revenues, collections, reporting and education. We will do this by continued outreach to other municipalities and ADOR when changes occur and utilize all reporting mechanisms available and do not stick with the norm of estimating during changing environments, such as what is happening globally in retail and locally in contracting. We are in discussion with other municipalities on how they are making that transition and determine what is the right course of action for Flagstaff, when major changes are occurring, such as the transition of duties to ADOR.

Staff looks forward to discussing the information above at the October 22, 2019 Work Session with Council. Staff will also be analyzing providing an update on our Restaurants, Bars, and Hotel sales tax categories (the additional 2% sales tax imposed on these tourism-related businesses), and our sales tax revenues that are dedicated for specific Transportation purposes approved by the voters.

Finally, staff is proactively exploring the formation of a fiscal plan for future economic downturns that should enable the City to follow, in a tiered fashion, certain prescribed measures in City expenditures coincident with prolonged, reduced revenues that reach defined benchmarks. This draft plan will be forthcoming.